Lawrence R. Velvel
Massachusetts School of Law
500 Federal Street
Andover, MA 01810
Tel: (978) 681-0800
Fax: (978) 681-6330
Email: velvel@mslaw.edu

David Bernfeld, Esq.
Bernfeld, DeMatteo & Bernfeld LLP
600 Third Avenue 15th Floor
New York, NY 10016
Tel: (212) 661-1661
Fax: (212) 557-9610
Email: davidbernfeld@bernfeld-dematteo.com

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES INVESTOR PROTECTION CORPORATION, **Plaintiff** **v.** **BERNARD L. MADOFF INVESTMENT SECURITIES LLC.** **Defendant.**	**Adv. Pro. No. 08-1789(BRL)** **SIPA LIQUIDATION** **(Substantively Consolidated)**
In re: **BERNARD L. MADOFF,** **Debtor.**	
IRVING H. PICARD, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC, **Plaintiff** **v.** **JPMORGAN CHASE & CO., et al.** **Defendants.**	**Adv. Pro. No. 10-4932 (BRL)** **No. 1:11-cv-913 (CM)**

AMICUS CURIAE BRIEF OF THE NETWORK FOR INVESTOR ACTION AND PROTECTION

STATEMENT

The Network For Investor Action And Protection ("NIAP") is a two year old organization with about 1,200 members which arose because of the Madoff debacle and seeks to protect against frauds that victimize investors. It especially seeks to protect small investors, who comprise almost its entire membership.

During the course of its existence, NIAP has been active in both legislative and judicial matters, and was allowed to file amicus curiae briefs in the Second Circuit on the question of net equity. NIAP has had the benefit of study of extensive writings on the economic, financial, legal and political aspects of the Madoff fraud, including the role played by large financial institutions in enabling that fraud.

In this amicus brief NIAP seeks to present its views regarding the question of red flags known to large financial institutions that facilitated Madoff's Ponzi scheme. The question of red flags is before the Court in this case, and NIAP has a deep interest in the question because, if the Court decides the question, as it may, the decision could have a major impact on cases that will be brought by members of NIAP.

ARGUMENT

Large Financial Institutions, Like JPMC, Which Knew Of Red Flags But Ignored Them In Service Of Reaping Large Profits, Should Not Be Permitted To Escape Liability.

It has long been understood that the Congressional purpose underlying the Securities Investor Protection Act is to protect the small investor and thereby build his confidence in markets. The protection of investors and of the integrity of securities

markets was likewise the goal of the 1933 Securities Act and of the 1934 Securities Exchange Act. Congress' repeated purpose of protecting investors and markets requires that frauds, including Ponzi schemes, be detected and stopped as early as possible, thereby lessening and at times even perhaps eliminating the losses caused by the frauds.

As the Madoff and Stanford cases have taught yet again, we cannot rely solely on governmental and quasi-governmental agencies to detect fraud early-on. The failure of the SEC (once a premier governmental body) and FINRA to detect Madoff's Ponzi scheme while it grew to be the largest fraud in financial history is proof enough that we cannot rely on government or quasi-government alone. The same is true with regard to the huge Stanford fraud. To stop fraud as early as possible, and thereby protect investors, we must, rather, as in so many other areas of economic and social life, enlist the cooperation and assistance of knowledgeable private professionals who discover the existence or possibility of fraud during the course of their professional work. Again as in so many areas of professional and economic life, we must marry those professionals' economic interests to the stopping of fraud when they learn of its existence or possibility.

To rely on knowledgeable private parties to root out illegality even though there also are governmental agencies devoted to the same purpose, and to marry the private parties' economic interests to this, is nothing unusual. It is one of the purposes behind antitrust treble damage suits, behind suits for discrimination in the workplace, and behind whistleblower suits. The principle is as applicable here, in the securities fraud area, as it is there.

The worst possible thwarting of Congress' goal of protecting investors, especially small ones, would be to do the opposite of marrying professionals' economic interests to

the rooting out of fraud. For such opposite would be to permit professionals to take advantage of known or suspected frauds, including Ponzi schemes, by making large profits from frauds at the expense of unsuspecting innocent investors. When a financially expert institution learns of facts giving rise to the suspicion of fraud, fidelity to the intent of Congress, and fidelity to plain honesty and decency, require the institution to try to determine the truth -- the expert institution is on inquiry notice because it suspects fraud -- and also require the institution to report the unhappy facts to government agencies charged with maintaining honesty in investments -- the SEC, FINRA and state securities commissions -- so that wrongdoers can both be stopped and brought to justice.

The idea that one cannot remain silent and take advantage of a possible problem -- here the idea that large financially expert institutions which learned of facts that, given their knowledge and expertise, should have put them on inquiry notice that Madoff was a fraud and they should not use the Madoff fraud to reap huge profits without investigating the situation first -- is not a new or novel idea in American or English law. For scores or hundreds of years knowledgeable parties have not been permitted to remain silent while making fortunes because of innocent victims. A manufacturer of airplane parts who reasonably suspects possible defects that could cause a plane to crash cannot with impunity sell the parts to an airplane manufacturer without providing notice of the possible defects, and make fortunes from doing so. Rather, the manufacturer must take steps to determine whether the defects exist and must correct them if they do exist. The parts manufacturer who fails to take these remedial steps will be liable to persons (or their heirs) who are injured or killed in crashes caused by the defective parts. The same obtains with regard to the manufacturer or seller of car parts, and with regard to

companies which manufacture medicines. To speak of impunity from suit by injured third parties for such culprits would be considered ludicrous. To speak of them as having no duty to foreseeably injured or killed third parties, and as being able to benefit financially to the tune of hundreds of millions or even billions of dollars from their failure to seek to detect the truth and make corrections, is similarly ludicrous, since it is just another way of granting immunity from suit for reprehensible and immoral conduct.

Yet it appears that here, where the same principles are applicable, certain large financial institutions -- which are said to have made enormous sums from or because of Madoff while suspecting that a fraud was in progress -- are claiming that they had no duty to investigate and are not liable to third parties whose injuries were not only foreseeable but were certain to occur at some point. It is also claimed that this is demanded by the banking law of the Second Circuit -- which has never faced a problem of such magnitude as the current one, a problem involving a fraud that is by far the largest in history and was enabled by large banking institutions, the same kind of institutions and sometimes the very same institutions whose reckless conduct caused the current devastating recession.[1] Why these large institutions should be able to make fortunes while evading Congress' repeatedly implemented desire to protect small investors escapes us. And why these large institutions should escape the principles of duty, investigation and corrective action applicable to, say, manufacturers of airplane or car parts or manufacturers of pharmaceuticals, likewise escapes us. Evasion of responsibility for failure to investigate reasonable and sometimes strongly-held

[1] The claim being made about what allegedly is demanded by Second Circuit banking law is very dubious at best. The subject is discussed in *Lerner* v. *Fleet Bank*, 459 F.3d 273 (C.A. 2, 2006).

suspicions while making fortunes because of the crime seems to be the result of limitless greed.

The attempted evasion of responsibility for failure to investigate in the face of red flags, while making giant sums because of Madoff's fraud, is an unconscionable device for enabling the large institutions to escape from liability scot-free. It will cause innocent small investors *not* to recoup their losses because, without recovery from the culpable institutions which made fortunes while ignoring badges of fraud -- i.e., while ignoring red flags -- the losses of the innocent investors cannot be sufficiently recouped. This untoward, anti-Congressional-intent result is only the more indefensible when one considers the nature of the red flags themselves, all of which -- or nearly all of which – were generally unknown to the small investor, but many of which -- sometimes most or all of which -- were known to the large institutions or investors whose cases have been brought to the District Court for the Southern District by withdrawals of references. So powerful and well known to institutions were these red flags that it is proper to regard the institutions as having actual knowledge that some kind of fraud or illegality was in progress and that its precise nature might very well be a Ponzi scheme. Some of these oft-flagrant red flags apparently were known to *all* the large professional financial institutions whose cases are now before the District Court for the Southern District, and the Trustee has mentioned most or all of these red flags in complaints and briefs. Others of the red flags, also mentioned by the Trustee, were known to *some* but not all of these large institutions. But rarely if ever were *any* of them known to small investors. Here are some of the more important ones that have been talked of since Madoff's fraud was revealed on December 11, 2008 -- since Madoff got busted, one might say:

1. Because of the amount of money he supposedly was running, the execution of Madoff's split strike conversion strategy required more options than existed on exchanges or, apparently, in the world. Nor would Madoff identify the supposed counterparties from whom or to whom he supposedly was buying and selling options over the counter.

2. Madoff appeared to have an uncanny, and impossible, ability to buy stocks at their lowest price on a given day and to sell them at their highest price on a given day.

3. Madoff did his own custodial and clearing functions. There was no way to know whether the assets he claimed to be holding really existed.

4. Madoff was extraordinarily secretive: he would not meet with experts who wished to do due diligence, would refuse to respond to crucial questions when he did meet with them, and forbade his feeder funds from mentioning that they had put their money with him.

5. Though the 703 Account at JPMC was supposedly for the purpose of buying and selling securities (by the scores or hundreds of millions of dollars at a time), no money went out of the account to securities dealers from whom stocks would have been bought and no money came into it from securities dealers to whom stocks would have been sold.

6. Though Madoff supposedly was buying and selling huge quantities of stocks, his supposed trading could not be "seen" in the market and never seemed to move the market.

7. Madoff's accountant was a one-man shop. Nor was it registered with the Public Company Accounting Oversight Board or subject to peer oversight.

8. So called FOCUS reports that Madoff filed with the SEC were false. They vastly understated cash and loans.

9. Wall Street was rife with rumors that Madoff was a fraud -- that he was illegally front running or a Ponzi scheme. People on Wall Street knew of these rumors but kept the rumors to themselves.

10. Family members held the highest positions at Madoff's firm.

11. Experts were unable to replicate his results.

12. Madoff obtained his compensation in a way that experts found incomprehensible because he left vast sums on the table.

13. Regular transfers of huge sums went back and forth scores of times between Madoff and Norman Levy for no observable business purpose, thus indicating that the 703 fund was being used for some unknown nefarious purpose.

14. Experts though Madoff's results were too good to be true.[2]

15. Various characteristics of Madoff's scheme appeared to ape those of other schemes which had been exposed, such as the Petters, Bayou and Refco frauds.

There were other red flags as well as those listed above, but the foregoing list illustrates that there were major badges of fraud, observable to Wall Street experts, which should have resulted in them investigating Madoff's scheme, refusing to do business with him (as a few did refuse because of suspicions raised by red flags), and blowing the whistle on him to state and federal authorities. In fact, knowledge of particular red flags -- such as the lack of sufficient options to support Madoff's purported trading, his ability to always sell at a day's highest price and buy at it's lowest, the inability to "see" his supposed buying and selling in the market, the failure of monies in the 703 Account to be used to buy securities or to flow in from the sale of securities, and Madoff's false reporting to the SEC -- were not only badges of fraud that should have resulted in banks

[2] To the unsophisticated small investor, Madoff's results seemed explicable for several reasons. There were highly successful mutual funds which made more than he did over 10 and 15 year periods. His investment results also were no better than and sometimes were below, even *far* below, the amounts made by recognized investment leaders like Bill Miller of Legg Mason, who finished ahead of the S&P for fifteen straight years, Warren Buffett, Bill Gross of PIMCO, Julian Robertson and George Soros. These people were (and are) recognized as having unusual financial acumen, and to small people there was no apparent reason why Madoff wasn't another such individual. As for the consistency of his returns, and the sparse periods of losses, this seemed plausible to average investors because Madoff did not seek large gains but only small incremental gains, which is a technique for avoiding losses, and, *very* importantly, he supposedly bought options that provided downside protection. Not to mention that his technique appeared to conform to Warren Buffett's three well known (and oft proven right) rules for investment success: (1) Don't lose money. (2) Don't lose money. And (3) never forget rules 1 and 2. Experts on Wall Street, however, regarded Madoff's results as inexplicable and too good to be true, but kept their opinions largely to themselves and certainly did not make their opinions public, so small investors never knew of them.

refusing to continue doing business with Madoff, but were proof that some form of fraud was in process and that it likely was a Ponzi scheme. Indeed, if one knew the foregoing facts relating to monies in the 703 Account not being used to buy securities and not stemming from the sale of securities, one *had* to conclude the fraud was a Ponzi scheme.

That the existence of some form of fraud was self evident, or should have been, to financial professionals is reflected in quotations in the Trustee's amended complaint against J.P. Morgan Chase dated June 24, 2011. The amended complaint quotes one Wall Street figure, "Robert Rosenkranz of Acorn Partners, a fund of funds manager and an investment adviser to high net worth individuals," as saying that Accorn *had* performed due diligence on Madoff years before December 11, 2008, and had "concluded [on the basis of only a few of the red flags, not nearly all of them or even half of them] 'that fraudulent activity was highly likely.'" Trustee's Amended Complaint Against JPMorgan Chase dated June 24, 2011, pp. 67-68. Acorn had thought that even the relatively few badges of fraud it observed "'were not merely warning lights, but a smoking gun.'" It had believed "'that the account statements and trade confirmations [it had managed to get access to] were not bona fide but were generated as part of some sort of fraudulent or improper activity.'" (*Id.*, p. 68.)

The huge financial institutions whose cases have been removed from the Bankruptcy Court to the District Court via withdrawal of references did not do the due diligence which they *could* have done -- and that a few professionals like Acorn did do -- and which their knowledge gave them a duty to do. Instead, for their own massive financial benefit, these institutions, whose cases are now in the District Court, sucked small investors into Madoff's fraud and/or facilitated the fraud, thus indicating that the

Trustee is right when he repeatedly accuses these gigantic companies of forgoing their responsibilities to others in service of making huge sums of money for themselves.

Amici believe that financial institutions which ignored red flags known to them should not be allowed to escape liability, and particularly should not be allowed to escape it by arguing that they have no duty to inquire into the existence of a fraud that would devastate thousands of persons, could thus facilitate the fraud and make hundreds of millions or billions of dollars with impunity from suit, and can be liable only if they had *actual* knowledge that a fraud was taking place. To allow financial institutions to escape liability to innocent victims if the institutions did not have *actual* knowledge of fraud here, but only knowledge which they ignored of red flags indicating the possibility of fraud or, as Acorn thought, the virtual *certainty* of fraud, would be like allowing airplane parts manufacturers to escape liability to victims if they did not have *actual* knowledge, but only suspected, that there were defects in parts which then caused crashes that killed dozens, scores or hundreds of people. It would be like allowing drug manufacturers to escape liability to victims who are seriously sickened by or die from a drug which the manufacturers only suspected was defective but did not actually know to be defective.[3]

And it would frustrate the Congressional intent to protect investors, particularly small ones -- a Congressional intent *repeatedly* stated in the Congressional reports and rife throughout the floor debates on SIPA and its amendments. The only way to carry out that Congressional intent in the case of a giant fraud like Madoff's is to recover ill gotten

[3] Just as is true in the examples regarding defects known to parts or drug manufacturers, whether any particular financial institution had enough knowledge of red flags to be culpable is a question for the trier of fact. Our point is simply that the financial institutions, like manufacturers, cannot automatically escape from liability, as they are attempting to do.

money from those who facilitated the fraud -- a fraud whose size, devastation and facilitation by huge banking institutions has never before confronted the courts.

Here, as the Trustee has repeatedly said, the efforts of the large institutions whose cases have been withdrawn from the Bankruptcy Court to the District Court -- the large institutions that ignored red flags known to them -- were instrumental in enabling Madoff's fraud to keep going from about 1999 or 2000 to December 2008 -- to keep going even when Madoff's Ponzi scheme would otherwise have run out of funds and failed. By enabling the fraud to continue, the large banks' efforts caused there to be *thousands* of additional victims, caused a *vast* increase in the losses of investors who were in Madoff from the 1980s or 1990s and who innocently kept putting in more money or taking out (for living purposes) funds which they thought they had every right to but which the Trustee now seeks to claw back from them, and enabled the institutions to make nearly unimaginable sums of money. The protection of small investors envisioned by Congress, and fundamental long-standing principles of law long applicable to large companies, require that the culpable institutions here be liable to recompense the innocent investors, who sometimes are people of advanced age, and whose finances were blasted or destroyed by a fraud which the institutions greatly facilitated for their own multibillion dollar benefit.[4]

Respectfully submitted,

/s/ Lawrence R. Velvel
Lawrence R. Velvel, Esq.
Massachusetts School of Law

[4] The principles concerning red flags set forth in this amicus brief are applicable regardless of whether a lawsuit is permissibly brought against a large financial institution by the Trustee in order to recoup money for investors or is brought by the investors themselves. Whether the Trustee can permissibly bring third party claims to obtain money for investors is an issue that is currently before the Court. As the Court knows, the Trustee lost on this issue before Judge Rakoff.

500 Federal Street
Andover, MA 01810
Tel: (978) 681-0800
Fax: (978) 681-6330
Email: Velvel@mslaw.edu

/s/ David Bernfeld

David Bernfeld, Esq.
Bernfeld, DeMatteo & Bernfeld LLP
600 Third Avenue 15th Floor
New York, NY 10016
Tel: (212) 661-1661
Fax: (212) 557-9610
Email: davidbernfeld@bernfeld-dematteo.com

Attorneys for the *Amicus Curiae*

Dated: August 18, 2011

R:\My Files\Madoff\AmicusBrief.NIAPDistrictCt.doc